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Foreign Investment Law in Central and Eastern Europe

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and
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Policymakers should focus on reducing uncertainty and transaction costs through clear and simple legislation, the enforcement of contracts, the use of arbitration and other alternative dispute resolution mechanisms, stronger protection of property rights, the dissemination of information on laws and on business opportunities, and an end to unnecessary bureaucratic intervention.

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This paper — a product of the Transition and Macro-Adjustment Division, Policy Research Department — is part of a larger effort in the department to analyze the economic impact of legal reform in Central and Eastern Europe. Copies of the paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Maxine Berg, room N11-057, extension 31450 (March 1993, 21 pages).

One of the most remarkable developments in Central and Eastern Europe (CEE) has been the region's opening to foreign direct investment. CEE states saw foreign investment climb from minuscule amounts in 1989 to more than $7 billion in 1992. All CEE states have enacted new laws on foreign investment as well as related legislation in areas such as taxation and company and environmental law.

Gray and Jarosz describe these efforts at legal reform and assess their impact on foreign investment in light of what is known about investor motivation. They concentrate on the role of foreign investment law, referring occasionally to other aspects of law that apply to domestic and foreign investors. They find that specialized foreign investment laws can play a useful role during the transition to a market economy. Of particular importance is their role in sending a strong signal to foreign entrepreneurs that the host country is serious about economic reform and is willing to work with investors to establish mutually beneficial arrangements.

Foreign investment laws are also often used to target special incentives to foreigners and create an island of legal development that may differ from — and sometimes outpace — other legal development. In such ways they tend to create investment "enclaves." But to the extent that an enclave separates foreign from domestic investors, it can quickly outlive its usefulness. The incentives it fosters may not only bleed domestic treasuries, but may also lead to bureaucratic structures that complicate the investment environment and elevate information and transaction costs for foreign investors. As quickly as possible, the transforming economies should dismantle the enclave and put domestic and foreign investors on an equal footing. This may well mean that foreign investment laws are no longer needed. The Czech and Slovak Federal Republic was the first CEE country to abolish specific foreign investment legislation in favor of a broad commercial code covering all investors.

If an enclave does exist, policymakers should focus on the concerns critical to foreign firms. In the design of investment laws to date, the CEE countries have perhaps paid too much attention to preferential tax schemes, ignoring other costs foreign investors face. Policymakers should focus on reducing uncertainty and transaction costs through clear and simple legislation, contract enforcement, arbitration and other alternative dispute resolution mechanisms, stronger protection of property rights, dissemination of information on laws and on business opportunities, and an end to unnecessary bureaucratic intervention. Complex regulations not only increase investor uncertainty but divert bureaucratic resources that the host country cannot afford to squander.

Foreign Investment Law in Central and Eastern Europe

Cheryl W. Gray and William Jarosz

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FOREIGN INVESTMENT LAW IN CENTRAL AND EASTERN EUROPE

Rarely in economic history has change been as rapid and dramatic as that which has occurred in Central and Eastern Europe (CEE) since 1989. Four years ago private enterprise was not only unknown but illegal in many of the CEE states. Isolated behind regulations imposed by communist governments and Western bans on trade, these states were largely cut off from the world economy.

One of the most remarkable developments during this period has been the opening of the region to foreign direct investment (FDI).[1] CEE states saw foreign investment climb from minuscule amounts in 1989 to over $US 7 billion in 1992. Legal reform has been central to this process. All CEE states have enacted new laws on foreign investment as well as related legislation in areas such as company law, taxation, and environmental law.[2] After briefly outlining the importance of foreign investment to the region, this paper describes these efforts at legal reform and attempts to assess their impact on foreign investment in light of what is known about investor motivation. The paper concentrates on the role of foreign investment law per se, although other aspects of the legal framework that apply to both domestic and foreign investors may occasionally be referred to.[3]

The Importance of Foreign Investment to the Region

A report issued in 1992 by the United Nations Centre on Transnational Corporations labels transnational corporations, and the investments they make, as "engines of development."[4]

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1. All discussion of foreign investment in this paper refers to foreign direct (as opposed to portfolio) investment.

2. Czechoslovakia adopted a new foreign investment law soon after its 1989 revolution, but such legislation was subsequently superceded by the new Commercial Code, which took effect in January, 1992, and covers both domestic and foreign investors.

3. For a survey of underlying legal frameworks for private sector development in CEE, see Gray et.al., "The Legal Framework for Private Sector Development in a Transitional Economy: The Case of Poland," Georgia Journal of International and Comparative Law 22:2 (Spring 1992); Gray, Hanson and Ianachkov, "Romania's Evolving Legal Framework for Private Sector Development," The American University Journal of International Law and Policy 7:3 (Spring 1992); Gray and Stiblar, "The Evolving Legal Framework for Private Sector Activity in Slovenia," University of Pennsylvania Journal of Business Law, forthcoming (Spring 1993); Gray and Ianachkov, "Bulgaria's Evolving Legal Framework for Private Sector Development," The International Lawyer, forthcoming (Winter 1993); Gray, Hanson, and Heller, "Legal Reform for Hungary's Private Sector," The George Washington Journal of International Law and Economics, forthcoming (March 1993); Gray, "The Legal Framework for Private Sector Activity in the Czech Republic," Vanderbilt Journal of Transnational Law, forthcoming (May 1993).

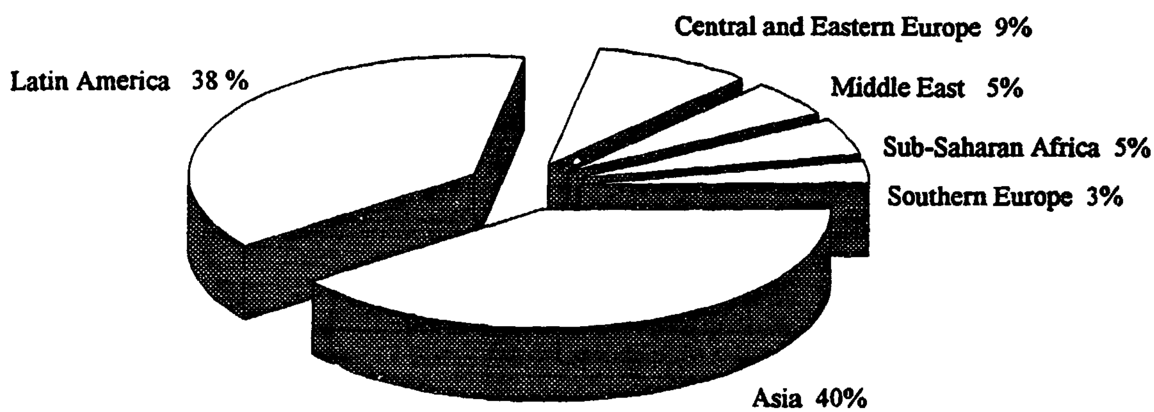
4. United Nations Centre on Transnational Corporations, World Investment Report 1992: Transnational Corporations as Engines of Growth; New York: United Nations, 1992.

In the second half of the 1980s, foreign investment grew three times faster than domestic output, and for many countries it is a stronger tie to the world economy than trade. In 1991, over 35,000 transnational corporations invested approximately $US 154 billion in the world economy. Developing and transitional countries captured about 16 percent of this--some $US 25 billion.

Since abandoning central planning and turning to market reforms in 1989, the CEE countries have enthusiastically sought the capital, technology, and management skills offered by foreign investors. Foreign investment in these countries has grown rapidly from a very low base and now accounts for about 9% of total FDI flows to developing and transitional countries (Figure 1). The latest available figures, albeit quite rough, show steady growth in both numbers of direct investments and cumulative value across the region, with Hungary leading the way in both total FDI and FDI per capita terms (Figures 2 and 3[5]). Several studies forecast that in the 1990s the countries of CEE and the former Soviet Union (FSU) could attract as much as $US 50-75 billion in foreign investment.[6]

Despite this auspicious entry into the world economy, the level of foreign investment in the CEE region is only a tiny fraction of what is needed. New investment is needed to turn

Figure 1:
Value of Foreign Investment
(cumulative until mid-1992)



Source: World Bank, "Attracting Private Investment," EMENA Technical Department, September, 1992

5. It is very difficult to obtain accurate data on foreign investment commitments and flows. Data are not readily comparable across countries because of different accounting methodologies, and even within a single country different sources give highly variable figures. Figures 2-4 show the authors' best estimates, compiled from various sources. They should be treated as rough indicators only.

6. Studies cited in United Nations, supra note 4, p. 32.

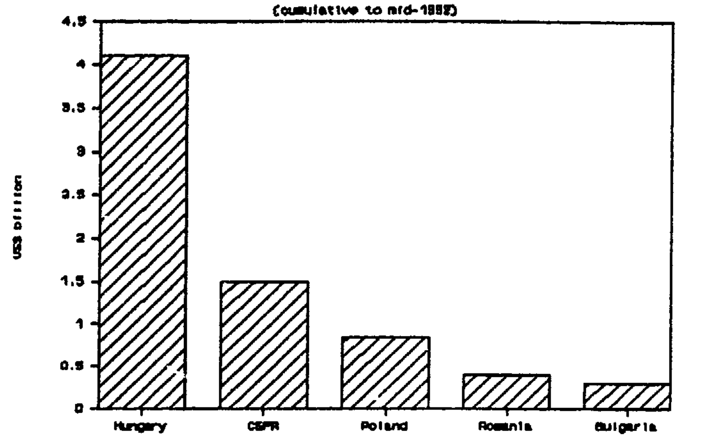


Figure 2: Value of Foreign Investment
(cumulative to mid-1992)

around CEE economies, which are now suffering from a production decline that surpasses even that of the great depression of 1928-32. Furthermore, foreign capital is needed to finance privatization and restructuring of state owned enterprises. For example, Jaroslav Prochazka, the former director of foreign relations at the Ministry of Industry of the Czech and Slovak Federal Republic (CSFR), estimated that restructuring in 1992 alone would require between $US 1.8 billion and $US 2.2 billion, and that domestic sources could cover only 40% of the total. Prochazka noted that "foreign investment is one of the essential conditions for the effective restructuring of industry and also of the future prosperity of the country."[7] The Russian Deputy Prime Minister, Alexander Shokhin, declared that the Russian government would seek $US 5 billion in foreign investment by mid-1995. This is more than double the total foreign investment in Russia since 1987,[8] but it is very little in the context of Russia's gigantic need for restructuring and new investment. In comparison, in the first 2 years after reunification Germany poured over $US 100 billion into its eastern half.[9]

While the need for foreign investment is up sharply in CEE and the FSU, the global environment for direct investment is growing more competitive for two reasons. First, while absolute flows of foreign investment continue to grow, the rate of increase has fallen due to the sluggish economic growth in the United States, Japan, and Western Europe. Increases in direct investments by Japanese corporations provided much of the growth in foreign investment flows in the 1980s. From 1985 to 1989, Japanese corporations increased their foreign direct investments at an average annual rate of 62 per cent. However, direct investment fell in the early 1990s. In the year ending March 1992, Japanese foreign direct investment was $41.6 billion, compared to $56.9 billion in the previous year, and Japan's overall European investment was down $5 billion.[10]

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7. J. Prochazka, "Unfreezing the flow of capital to the Czech Republic," Central European, no. 14 (July/Aug. 1992), p. 34.

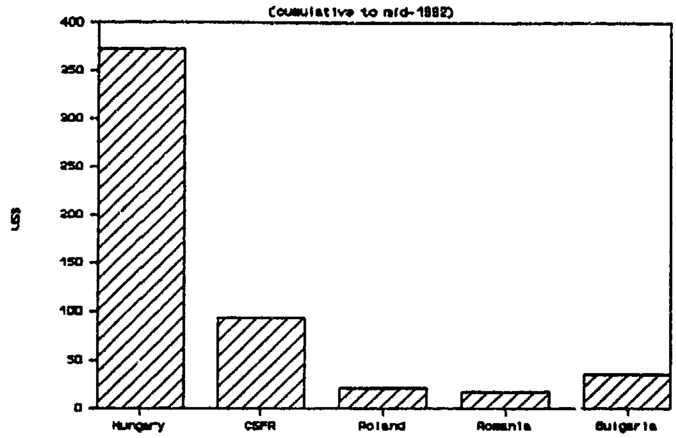
8. Agence France Presse, July 17, 1992.

9. L. Gay, "Point of no return," The Atlanta Journal and Constitution, May 24, 1992, p. G-7.

10. Reuters, June 5, 1992.

Second, just as the growth of the supply of direct investment is decreasing, competition for investment funds is picking up across the world as a new group of countries attempt to hitch on to the growth engine of FDI. New players, such as Laos and Vietnam in East Asia, India in South Asia, and Cuba in the Caribbean, have revised their regulations restricting foreign investment and opened their economies to flows of foreign funds. And well-established players, such as the ASEAN countries, are growing even more competitive as their economies continue to expand and their investment climates become even more favorable.

Figure 3: Per Capita Foreign Investment



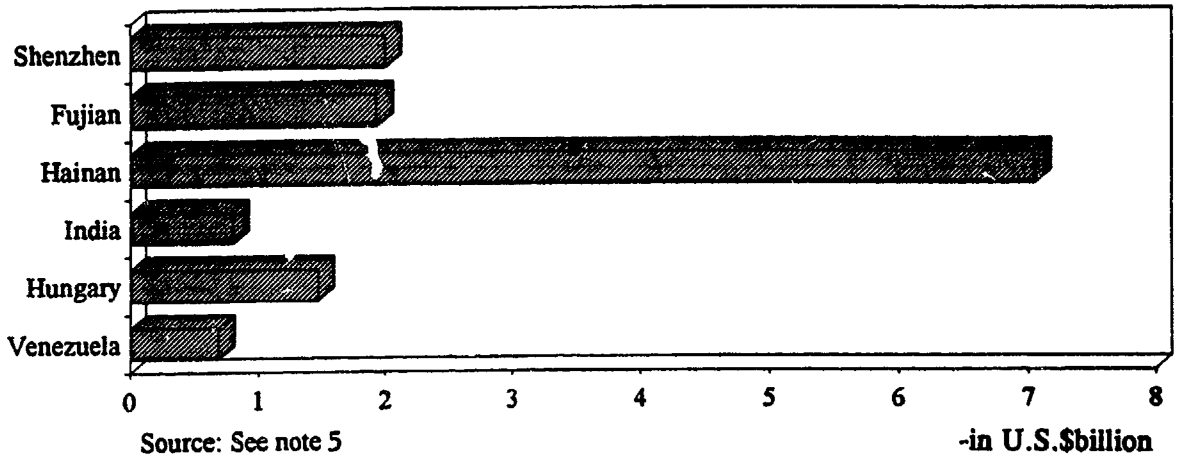
As noted earlier, the strongest magnet for foreign investment in the CEE region has been Hungary, attracting almost two-thirds of the investment in the region since 1989. But when growth of investment in Hungary is compared to the levels of investment in other successful developing states--such as the special economic zones of China and some of the more recent entrants into the global economy, India and Venezuela--the competition that CEE faces in attracting investment to CEE becomes clear (Figure 4).

In sum, the CEE countries face a daunting challenge. Their need for foreign capital and know-how to repair their economies and stimulate growth is immense. Yet the rate of expansion of global investment has decreased, and competition for foreign funds, technology and management skills is tighter than ever. How are the CEE states restructuring their foreign investment regimes to promote investment? Do their laws appeal to the concerns of foreign investors? Before turning to the legal framework, we take a brief look at investor motivation, because designing an appropriate legal framework conducive to foreign investment requires at least a basic understanding of what motivates investors.

Why Do Firms Invest Abroad?

The subject of investor motivation has received a great deal of attention in the academic literature and in policy circles, spawning a vigorous debate which has continued since the

Figure 4:
Value of Foreign Direct Investment
October 1991 - March 1992



1960s.[11] This research has found, above all, that motivations which lead firms to invest abroad are complex and are likely to vary from manufacturing to service industries, from acquisitions to greenfield investments, and from export to import-substituting industries.

Much of the discussion implicitly borrows from the standard model of foreign trade, the Heckscher-Ohlin-Samuelson (HOS) model. The HOS model argues that differences in factor endowments drive trade. Countries rich in capital export capital intensive goods, and countries rich in labor export labor intensive goods. An analogous model is then applied to foreign investment: production moves abroad in response to lower costs, due either to lower factor prices or other specific "locational" cost advantages. One such "locational" cost advantage that drives many investment decisions is that caused by host country tariff barriers, which protect domestic production from trade competition and thereby force foreign firms to invest if they are to service the host country market.

To take a CEE example of "locational" advantages, the Gerber division of H.J. Heinz recently committed $US 25 million to acquire a 60 per cent stake in Alima SA, a leading baby

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11. For a review of the state of the literature, see John Cantwell, "A survey of theories of international production," in C. N. Pitelis and R. Sugden, eds., The Nature of the Transnational Firm, New York: Routledge, 1991. In writing this paper, this literature has been supplemented by questionnaires and follow-up interviews with a sample of American firms who have considered investing in the CEE region.

food and fruit juice maker in Poland.[12] Alima was an attractive target for investment because of its relatively modern machinery and its location near supplies of fruit and packaging and near growing markets (in CEE as well as Western Europe). According to one analyst, purchasing Alima and shipping throughout Europe will cost one-tenth as much as attempting to service the European market from plants in the United States.[13]

Although specific "locational" advantages are clearly important, they do not fully explain patterns of foreign investment flows.[14] Indeed, direct investment is not the only way firms can reap the benefits of differential factor prices. Rather than invest directly, foreign firms can trade informally or through long-term contracts, or they can license technology to foreign firms for production abroad.[15] In deciding to invest in production abroad, the firm is calculating that there is a net benefit to bringing the operation inside the structure of the firm, rather than buying the product on the market and re-selling it or licensing technology to foreign producers. In other words, the foreign firm believes that it possesses specific advantages that enable it to produce and/or market at lower cost than domestic firms.

Economists have classified the potential advantages possessed by foreign investors into two types: ownership advantages and internalization advantages.[16] Ownership advantages are those assets that are specific to the foreign firm itself, such as superior technology or special management skills. Internalization advantages are those benefits that accrue to any modern corporation from organizing and coordinating a variety of tasks in a single organization, most notably a reduction in transaction costs. Thus, to return to the example of Gerber, it is not just that wage, input, and transport costs are lower in Poland. Polish firms also operate with these same factor prices. It is also that Gerber possesses some specific advantages: ownership advantages, in that it has a recognized brand name that differentiates its product, and internalization advantages, in that its combining of manufacturing, marketing and distribution in a single corporate structure lowers costs and increases efficiency.

The legal framework affects all three types of advantages--those gained from location,

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12. International Herald Tribune, July 28, 1992; Bill Vlasic, "Gerber gobbles up big Polish baby food firm," The Detroit News, October 4, 1991, p. E-1.

13. Interview, Washington, D.C., July 28, 1992

14. Cantwell, supra note 11.

15. These alternative strategies are arrayed along a spectrum from pure market transactions (trade) to hierarchical transactions (direct investment). O.E. Williamson, Markets and Hierarchies: Analysis and Antitrust Implications, New York: Free Press, 1975.

16. For a summary, see J. H. Dunning, J. A. Cantwell, and T.A.B. Corley, "The Theory of International Production: Some Historical Antecedents," and M. Casson, "General Theories of the Multinational Enterprise: Their Relevance to Business History," in P. Hertner and G. Jones, Multinationals: Theory and History, London: Gower, 1986.

from ownership, and from internalization. Much of the academic discussion to date has focused on the effect of government policies and legal rules and regulations on the first type, i.e., the cost of various factors of production. The effects can be pro or con--for example, minimum wage or other employment-related rules can drive up labor costs and thus deter investment, while tax incentives can lower the cost of capital and thus attract investment. But policies and regulations that affect the ability of foreign firms to apply their ownership advantages or internalization advantages also affect the profitability of multinational enterprises and thus their decisions to expand abroad. For example, weak legal codes that fail to protect proprietary intellectual property discourage the application of firm specific assets and thus deter investment. Similarly, overly-aggressive antimonopoly laws can vitiate the internalization advantages of multinational firms and thereby discourage investment. As discussed below, CEE policy makers should carefully consider these various dimensions of investor motivation when developing the legal framework for foreign investment.

How Do CEE Laws Affect Investment Decisions of Foreign Firms?

Prior to the first World War, foreign investment was a prominent feature of the regional CEE economy. The legal codes in these countries generally supported the institutions of foreign investment, and many of the major industries in the region were built by foreign entrepreneurs.[17] The communist governments that came to power after the second World War effectively limited foreign involvement in the region's economies to co-production agreements or the purchase of turn-key manufacturing plants. By the end of the 1970s there was an awareness throughout the Eastern bloc that the technology gap with the West was growing larger, and that the old methods of purchasing technology were not effectively raising the technological level in the region. Thus, in 1971 Romania began to change its regulations governing foreign investment in the hope of luring technological change. Other CEE states slowly followed suit, but given restrictions on foreign ownership, lack of currency convertibility, and a host of other roadblocks, Western investment remained negligible through the 1980s.

Only after the dissolution of communist power in 1989 did these states begin to change their investment climates in a concerted effort to attract foreign investment. Yet, at the beginning of the post-communist period there was a somewhat schizophrenic quality in their legal regimes governing foreign investment. Leaders were keenly aware of the need for investment yet sensitive to political charges of "selling out" to foreigners. On a state visit to Britain in the spring of 1991, Lech Walesa the Polish president sought to drum up investment in an interview with the Financial Times: "You in the West have over-production. You can make money out of our shortages and our stupidity--and we have plenty of that. . . Come and

17. In CEE, many old laws that technically governed foreign investment remained on the books throughout the Communist period, although they were overruled or replaced in practice by government decrees and regulations. In the post-communist period many of these old laws have come back to life. The commercial code of Poland, for example, is basically the law of the 1930s.

set up a factory here. Make money."[18] As encouraging as Walesa's remarks sounded, the Polish investment law in force at the time allowed foreign enterprises to repatriate only 15 per cent of the profits they earned in Poland. Even now, as GDP levels continue to decline across the region, foreign investment remains a target for some opposition politicians. For example, although the CSFR (and its successor states, the Czech Republic and Slovakia) have pushed ahead with legal reforms and attracted reasonable amounts of investment to date, Zbynek Kozel, deputy international secretary of the Social Democratic Party, recently charged that foreign investment is "a dangerous sellout."[19]

The origin of much of the anti-foreign sentiment which surfaces from time to time in the CEE states is the separate and often privileged treatment that has been granted to foreign investors. One of the central characteristics of the first stage in the transition from a socialist to a market economy has been the creation of a special "enclave" for foreigners. The enclave typically serves at least three purposes. First, it provides an important information--or "signaling"--function to potential investors. Second, it provides a limited sphere in which legal development can proceed differently and often more rapidly, thus bypassing many of the hurdles to legal and institutional development in the economy at large. Third, it allows for special incentives to be targeted to foreigners--those who are perhaps seen to be most influenced by them. All three purposes apply to some extent in developing countries more generally--where ever the underlying legal and incentive frameworks for private sector activity are unclear or weak. However, their rationale is particularly strong in the CEE context because of the magnitude of the systemic changes needed to meet the needs of foreign investors.

While these purposes may be valid, the enclave approach entails major costs, as discussed later, that must be weighed against its benefits. The sooner a country can move to dismantle the enclave and provide equal treatment for domestic and foreign investors, the better.

Signaling Potential Investors

Interviews with multinational firms consistently indicate that uncertainty is a prime impediment to investment in the CEE region. Firms may not be familiar with the legal regimes or with potential joint venture partners, and getting information is costly. A valuable and often overlooked function of foreign investment law is to send a strong, positive signal to potential investors. While vaguely worded declarations may not assuage investor's concerns, the passage of clear and supportive foreign investment legislation does convey the message that investment is welcome.

Recognizing the important signaling effects of changes in the legal regime governing foreign investment, all of the CEE countries issued declarations early in their transitions guaranteeing the security of foreign investment. These declarations were accompanied or

18. "Visionary seeks an equal chance," Financial Times, April 23, 1991, p. 19.

19. Robert Cohen, "Czechoslovakia's Wall Street brigade," New York Times, June 21, 1992, p. 1.

quickly followed by new or amended foreign investment laws, changes in the tax regimes applicable to foreigners, and bilateral investment treaties with investors' home countries.[20]

Even with these early steps, firms face continued uncertainty in the broad legal regime governing foreign investment in the region. Across the region the laws in many areas--from the rights of former landowners to recover title, to rules on liability for previous environmental damage, to regulations governing the financial sector--remain in flux. Foreign entrepreneurs recognize the risk inherent in investing in any reforming economy. Yet they also recognize, as one businessman noted, that "if you wait for the risk to disappear, the opportunity will also disappear."[21] Foreign investors' attitudes toward risk are highly variable, but it does appear that the passage of legislation that indicates that the government is serious about encouraging and protecting investment is an important first step.

Developing the Legal Framework

A second rationale for the enclave strategy is to provide a separate legal framework for foreign investors. On the one hand, such a framework may be needed to police access to the incentives discussed below. This is the reason, for example, for special entry regulations, as discussed below. On the other hand, such a framework can provide a semblance of order, predictability, and enforceability in an otherwise highly uncertain and undeveloped legal environment. Such a legal framework does little to lower factor costs, but it can go far in creating an environment in which firms can realize ownership and internalization advantages. While progress has been made in this area in all CEE countries, there is still a long way to go.

The legal and regulatory costs of organizing and operating joint ventures or wholly-owned subsidiaries in a host country fall into two broad categories: *ex ante* costs and *ex post* costs. *Ex ante* costs are the costs associated with setting up the venture. These include negotiation costs and all of the costs incurred in obtaining government approval for the transaction. The costs in shepherding an investment through a tangle of government procedures for licensing and registration can be significant, and can discourage firms from entering the market. *Ex post* costs are those incurred in running the organization. Most typically, *ex post* costs arise in policing the original agreement, protecting property rights, and settling disputes. Legal developments that reduce these various costs help firms to realize ownership and internalization advantages and thus improve the overall investment climate in a country.

Making new investments. Most countries in the region have significantly eased the process of establishing new, or "greenfield" investments. All countries allow foreign firms to set up wholly-owned subsidiaries, thus eliminating the requirement to find domestic partners and

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20. For example, American investors are further protected in Poland, the former CSFR, and Bulgaria by those countries' bilateral investment treaties with the United States, and investors from EC countries are protected by certain provisions in the EC Association Agreements with Hungary, Poland, and the former CSFR.

21. Interview, Washington. D.C., August 4, 1992.

negotiate joint venture arrangements. While all countries in the region prohibit foreign investment in specific sectors (defense, energy, domestic telecommunications and banking being the most common), the process is now quite easy in other cases, typically very similar to that applicable to domestic firms.

Hungary led the way in streamlining the procedures necessary for government approval of foreign investments. In 1990, Hungary amended its Investment Act and eliminated the need for prior government approval of foreign investments, including wholly-owned foreign investments. Firms now must meet incorporation requirements applicable to all firms and register within thirty days of the adoption of their articles of incorporation. Poland followed suit in new foreign investment legislation enacted on June 14, 1991, and CSFR did the same in the enactment of its new Commercial Code that went into effect January 1, 1992. The Bulgarian foreign investment law rules that went into effect on February 1, 1992, drop previous minimum investment requirements of $US 50,000 and require prior government permission only for investments in natural resources, defense, banking, and insurance. Of all the CEE countries, only Romania continues to require prior government approval of all foreign investment, but even here approval is deemed granted if no decision is rendered in 30 days.

Acquiring ongoing businesses. While accurate figures on the relative numbers of greenfield investment are not available, it appears that they are heavily outnumbered by joint ventures or buy-outs of existing host country firms. Foreign firms generally prefer to operate through joint ventures or acquisitions, because working with domestic firms or acquiring their assets is easier than starting from scratch. Domestic managers often possess valuable knowledge of local markets, familiarity with established suppliers and customers, and contacts within the government that are difficult for the foreign firm to duplicate. Only when a foreign firm is introducing a new product is greenfield investment generally more advantageous.[22]

Unfortunately, from the perspective of foreign firms, investing in an ongoing enterprise draws them into the quagmire of privatization regulations. The details of the privatization programs differ in each country. In Poland and the former CSFR, the process has been split into separate procedures for "large" and "small" enterprises. However, in all countries there is direct government intervention in the process. While this is understandable given that governments are indeed the "sellers" of the firms being privatized, the direct involvement of the government in the selection of foreign partners and the approval of privatization proposals has caused confusion and uncertainty for many foreign investors. Administrative law remains one of the least developed areas of law in the CEE countries. Regularized procedures for official decisionmaking are often lacking; there are few established channels for public input into the process; decisionmaking if often opaque; and those turned down in the privatization process are generally given neither a statement of cause nor any opportunity to appeal the decision.

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22. For example, Levi Strauss has committed $US 20m over four years to manufacture Levi's jeans in Poland. The venture includes not only a greenfield manufacturing plant, but also integration forward into retailing. The cost of converting local garment plants to modern manufacturing was prohibitive, and franchising retail outlets was impractical due to lack of domestic capital.

The experience of McDonnell Douglas in Poland illustrates the frustration felt by many foreign firms in the wake of what appear to be arbitrary procedures. In June, 1991, following a decision by a special government commission, McDonnell Douglas signed a letter of intent with LOT, the Polish airline, to deliver nine MD 80 aircraft.[23] The letter of intent contained an "offset" clause in which McDonnell committed itself to invest $US 85 million in Poland's aircraft industry. Then in August the government reversed itself and gave authority to LOT to choose its supplier directly. Over the objections of the Solidarity trade union, LOT picked McDonnell's competitor, Boeing, despite the fact that Boeing had only promised offsets of $US 30 million. McDonnell claimed it had started to produce the airplanes and stood to lose several millions of dollars. Although there could have been justifiable reasons for the reversal, no official government explanation was given.

Experiences like these are now common throughout the region. In Hungary, the State Privatization Agency rejected Colgate-Palmolive's bid for a Hungarian cosmetic firm. After acknowledging that Colgate's bid was the "most serious" it had received, SPA refused to give a reason for the rejection. Noting the 18 months Colgate had spent on the proposal, a Colgate official complained, "It was lengthy, it was expensive, it was involved, and it was unsuccessful. The chapter is closed."[24] Similar experiences have occurred in Hungary involving PepsiCo and R .J. Reynolds.[25] One American attorney argued that experiences like these have caused some U.S. firms to pull out of the market completely.[26]

The lack of established, regularized procedures for the inclusion of foreign investment in privatization also may open the door to real or implied corruption in the host country. This may lead not only to possible economic losses, as projects are given approval on the basis of side payments rather than economic efficiency or feasibility, but also to political losses. Charges of bribery and corruption can easily erode popular support for economic reform in general and foreign investment in particular. Despite its having been the highest bidder, Gerber's investment in the Polish firm Alima has been criticized in the Polish press as tantamount to theft, because the decision process was largely hidden from public view and comment.[27] There are growing signs that governments in the region are increasingly sensitive to the need to maintain political support for the reform process, even at the expense of foreign investment. The Hungarian Minister in charge of privatization, Tamas Szabo, recently announced that domestic bids would

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23. Miroslaw Glogowski, "New Boeings for LOT," Warsaw Voice, September 22, 1991; Christopher Bobinski, "Polish aircraft workers near strike over Boeing order," Financial Times, September 20, 1991, p. 3.

24. Ken Kasriel, "Hungary's troubled business ties," Christian Science Monitor, July 7, 1992, p.2.

25. The Bureau of National Affairs, Inc., International Trade Reporter, v. 9, no. 33, August 12, 1992, p. 1402.

26. Interview, Washington, D.C., August 17, 1992.

27. Patricia Koza, "U.S. seeks smoother path for investment in Poland," United Press International, June 3, 1992.

now be preferred in the privatization process over similar foreign bids. Price alone would no longer determine ownership.[28] This change of policy may have little practical effect, given the lack of domestic capital, but it does send a signal which may create further uncertainty in the minds of foreign investors.

The relative *ex ante* costs of making an investment overseas can be significant.[29] Rather than focusing on tax incentives (discussed below), which are of questionable utility in attracting foreign firms, CEE countries should exert more effort in reducing the transaction costs faced by firms seeking to identify opportunities and make investments. Instead of constantly changing tax rates in an effort to optimize locational incentives, these states should concentrate upon creating stable, transparent environments in which foreign entrepreneurs can more easily calculate the costs and benefits of investing and make the actual investments with a minimum of time and effort.

The issue of national economic sovereignty will continue to be important. But the CEE states can best guard against opposition to foreign ownership by establishing clear, reviewable procedures that are transparent to both the interested public and the relevant foreign firms. In this way the public can be protected from bureaucratic corruption, and the firms can be assured that their efforts to invest will be fairly evaluated.

Repatriating profits. Ownership and internalization advantages of foreign firms cannot be fully reaped unless profits can be repatriated to the investor's home country. Indeed, profit repatriation is consistently cited by studies of investor motivation as being among the highest concerns of potential investors. In the early period of reform, the inability to repatriate profits was a significant hindrance throughout the region. Foreign exchange was scarce, and CEE governments reacted to this scarcity by limiting the rights of foreign investors to repatriate profits. Lack of currency convertibility made it relatively easy to enforce these restrictions. All domestic investment had to take place in local currency, and foreign firms were required to convert hard currency at a state-controlled bank. Poland and the former CSFR set limits on profit repatriation of 15[30] and 25 percent of profits, respectively, while Romania set sector-

28. "New privatization measures," East European Business Law, June, 1992.

29. According to some analyses, these costs are responsible for the regional clustering of direct investment by the industrialized countries. The United States is more likely to invest in Latin America, and Japan prefers south east Asia, because cultural similarity and past experience cause their firms to have relative advantages in reducing the transaction costs that accompany investment. This may be one reason for the predominance of German and Austrian investments in CEE. U.N. Centre for Transnational Corporations, supra note 4.

30. This limit did not apply if the firm generated sufficient net foreign exchange earnings to cover the amount repatriated.

specific limits ranging from 8-15 percent.[31]

Improvements in the balance of payments environment helped lead to changes in the law. Full repatriation of profits is now allowed in all CEE countries. Romania was the last to lift its limits--in May, 1992. All of the states except Hungary permit full repatriation of wages of foreign employees. Hungary limits wage repatriation to 50 per cent.

Protecting against government expropriation. The most severe cost imposed upon investments *ex post*, and the most extreme threat to any ownership advantage, is government expropriation. All of the governments in the region have moved swiftly and effectively to deal with this concern. First, governments have sought to extend protections in their domestic legislation. All now provide guarantees of compensation in the event of nationalization or expropriation. Second and more significantly from the viewpoint of American investors, Poland, the former CSFR, and Bulgaria have concluded bilateral investment treaties with the United States, and a treaty with Hungary is being negotiated. The investment treaties are important because they outline the procedures to be used in determining compensation in the event of nationalization or expropriation.[32] Third, fears of expropriation without compensation are further quieted by the membership of the former CSFR, Hungary, and Poland in the Multilateral Investment Guarantee Agency (MIGA). MIGA, constituted in 1988 as an independent self supporting member of the World Bank Group, offers insurance covering currency transfer restrictions, expropriation, war and civil disturbance, and breach of contract to private firms doing business in member states.[33] In sum, the fear of unanticipated costs due to expropriation has been greatly diminished through this interlocking set of guarantees provided by domestic legislation, bilateral treaties, and insurance.

Obtaining rights to real property. The inability to acquire ownership rights in real property can impose significant costs on foreign investors. Not only must they continually renegotiate use rights, always potentially subject to rival claims to the property, but they also face the possibility of an "expropriation" of economic rents by the party with full property rights. Suppose foreign investor F enters into a joint venture with host H to manufacture pins, and F installs a specialized pin-making machine on property controlled by H. F's position is much weaker than H's position, because F's asset is more specific to that particular investment. F cannot easily transfer specialized equipment because no alternative use may exist. This is not the case with the landowner. Without legal rights to real property, F cannot prevent H from

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31. Article 16 of the Foreign Investment Act set out a series of limits: (1) 15 per cent of profits in industries the Council of Ministers designates as important to the national economy; (2) 12 per cent for investments in agriculture, natural resources, industrial and agricultural production, construction, communications, and transportation; (3) 10 per cent for finance, banking and insurance; (4) 8 per cent in all other cases.

32. The EC Association Agreements with Poland, Hungary, and the former CSFR provide guarantees of national treatment, but are not explicit as to steps to be taken in the event of expropriation.

33. MIGA recently extended protection to Coca-Cola's $US 25m investment in a bottling facility in Poland.

threatening to breach the joint venture agreement and thus forcing a redistribution of the profits. Under these circumstances, foreign investors will be deterred from investing in capital that cannot be secured against this type of "holdup."

Rules on land ownership by foreign parties continue to evolve across the region. In Bulgaria, foreign persons or companies in which foreigners have a stake greater than 50% may not own agricultural land, forests or water resources. The other CEE states generally prohibit ownership of land by foreigners, but wholly or partially foreign-owned firms incorporated under domestic law are treated flexibly. Although rules are still somewhat unclear and untested, such firms are generally considered to be domestic legal persons and thus legally permitted to own land.[34]

Protecting intellectual property. Foreign firms often invest abroad to exploit technological advantages they hold over their rivals. Technology is an asset and a key to their competitiveness--a major "ownership" advantage. Investors will be less likely to invest in countries that do not safeguard intellectual property, just as they will be hesitant to invest where there is a danger of expropriation of physical assets.

Recent reforms in the intellectual property legislation of most CEE countries, taken in part under pressure from the U.S.[35] and other Western countries, have generally brought the legal protection of intellectual property more or less up to international norms. For example, patent protection has typically been extended to previously-excluded products, such as drugs, chemical compounds, and plant or animal varieties, and copyright protection has been extended to computer software. The terms of patent and copyright protection have typically been lengthened to the international norms of 20 and 50 years, respectively. Although protection for new inventions may be relatively clear, however, many issues loom in the transition from the old to the new system.

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34. In Poland, the Minister of Internal Affairs has the authority to approve foreign ownership of land by individuals, though this is rare. Foreign-owned firms must seek government approval for land purchases, but this is not generally denied. In Hungary, only a Hungarian person, legal or natural, may buy real property. Foreign individuals may not acquire property. Companies with a head office in Hungary and subject to Hungarian law are defined as legal persons under the law, even if they are wholly or partially owned by foreigners. However, companies with foreign participation must seek approval from the Council of Ministers and show that the property is necessary for business operations. In practice, this law has been treated quite liberally, extending to office space and living quarters for foreign employees. Romania and CSFR follow the general pattern of prohibiting land ownership by foreign individuals, but allow ownership by foreign firms.

35. Bilateral investment treaties between the United States and Poland, Bulgaria, and C.S.F.R commit the signatories to adhere to most major international treaties on intellectual property. The U.S.-Hungarian treaty is stalled on the issue of intellectual property protection, particularly protection of computer software and pharmaceuticals. EC Association Agreements with Hungary, Poland, and the former CSFR require the CEE signatory countries to improve the protection of intellectual property rights to reach the EC level of protection within five years.

All of the CEE countries are signatories to the major international conventions on intellectual property, including the Paris Convention for the Protection of Industrial Property, the Madrid Agreement Concerning the International Registration of Marks, and the Berne Convention. These conventions provide little protection, however, in the absence of well-designed and enforced domestic laws.

Enforcement capacity is an issue in all areas of intellectual property law. Although a registration procedure exists, can a holder of intellectual property rights actually protect those rights if another person infringes them? In the socialist state this was not much of an issue, because most rights--particularly in the case of patents and trademarks--were held by the state. Enforcement of intellectual property legislation will emerge as a critical issue as the private sector and foreign investment grow. Giving true meaning to these rights will require institutional strengthening in the registration agencies and the courts to insure that infringements can be identified, halted, and punished as appropriate and that the aggrieved party can be adequately compensated.

Enforcing agreements. The difficulty of enforcing contracts can be a significant impediment to foreign investment, particularly in developing countries where formal legal systems are often weak. The CEE states have made significant progress in this area, using a combination of external and internal institutions. Bilateral investment treaties play an important role in reducing *ex post* transaction costs by providing guarantees of third party arbitration. Most CEE foreign investment laws also permit third-party arbitration. The availability of arbitration helps to alleviate the concerns of many investors that the host country legal system may not be capable of predictable and timely contract adjudication. Yet arbitration does not substitute completely for a well-functioning judicial system, because it will be effective only if local judicial institutions are willing and able to recognize and enforce arbitral awards if needed.

The opportunity for arbitration is expanded still further through participation in the Convention of the International Centre for Settlement of Investment Disputes (ICSID). The former CSFR, Hungary and Romania have signed and ratified the ICSID convention. The convention provides a mechanism for arbitration between private investors and host governments. Because of the high level of government involvement in the privatization process, the government is often a party to investment contracts. Most third party arbitration mechanisms do not allow for arbitration when one of the parties to the contract is a government. Becoming a party to the ICSID convention adds another level of assurance to foreign investors.

Anecdotal evidence suggests that CEE domestic courts are often willing to follow established global business practices and uphold common Western interpretations of contract law. In 1990 a dispute arose in Hungary between the American firm Pratt & Whitney and the Hungarian state airline Malév.[36] Pratt alleged that Malév had entered into a binding contract

36. "Pratt & Whitney's dispute with Malév continues, Business Eastern Europe, v. 20, no. 41, October 14, 1991, p. 349-50.

for the purchase of aircraft engines by returning a letter of acceptance. In January, 1992, a Hungarian court ruled in favor of Pratt, applying the Vienna Convention for International Sale of Goods.[37] The Pratt case is important because Hungarian courts moved quickly and effectively to resolve the dispute despite Hungary's lack of a bilateral investment treaty with the U.S.. The application of the Vienna Convention is a positive sign to Western firms that the Hungarian courts will apply commonly recognized standards of conduct in adjudicating business disputes.

Similarly, CEE countries are looking to Western norms as they design their commercial legislation. For example, the new commercial code of the former CSFR, which took effect on January 1, 1992, parallels parts of the U.S. Uniform Commercial Code, especially Article 2 governing contracts.

Resolving conflicts among contracting parties is a complex task and requires well-developed institutions. Given the developing domestic legal system and the growing acceptance of third party arbitration, it appears that dispute resolution may be receding as a major impediment to investment in the region.

Hiring and firing workers. Labor relations are a potentially explosive issue for foreign investment in CEE. Decades of central planning and the lack of hard budget constraints on firms led to serious overstaffing in many cases. Western companies, as either sole owners or joint venture partners, want the freedom to restructure the work force to make these CEE firms competitive in global markets. Political leaders are naturally concerned that high levels of unemployment will quickly sap support for reform.

So far, CEE legislation does not restrict the rights of foreign companies to hire, train, or fire local workers, although foreign firms must of course comply with existing social security legislation and pay social security taxes defined by statute. In a number of cases, as part of specific privatization agreements, Western companies have committed themselves to a moratorium on reducing the work force in plants they control.[38] Given the sensitivities involved, an ad hoc approach developed through privatization negotiations is likely to be preferable to an across-the-board rule.

In some cases, foreign subsidiaries want to hire employees from their home offices to help transfer firm-specific knowledge and techniques, and thus reap specific ownership or internalization advantages. CEE countries have been fairly accommodating to this need, although foreign employees must often pass through a maze of regulations to obtain work permits and find housing. Romania is the only CEE state that specifically restricts the types of positions foreigners can hold. Romanian law allows foreigners to work only as managers or as

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37. "Hungarian court rules for Pratt & Whitney," Business Eastern Europe, v. 21, no. 5, February 3, 1992, p. 53.

38. Interview, Washington, D.C., July 21, 1992.

other specialized employees.

Providing Special Incentives

A third rationale for the enclave strategy is to direct incentives to foreigners, often implicitly if not explicitly in the belief that foreigners are more likely than domestic entrepreneurs to be decisively influenced by them. The emphasis on tax credits and subsidies to lure investors follows in part from the view that foreign investment responds to factor prices. Yet a single-minded emphasis on incentives overlooks the other reasons for foreign investment, i.e. that foreign firms may still invest if they can readily apply the ownership and internalization advantages they possess.

The primary incentives used in CEE to attract foreign investors are tax-related. As seen in Box 1, all CEE countries now offer generous tax incentives to foreign firms, incentives that are generally not available to domestic investors. These incentives significantly lower the effective rates of taxation. A recent study by the Foreign Investment Advisory Service (FIAS, part of the World Bank group)[39] estimated the following effective tax rates as of mid-1991 on typical foreign investments in manufacturing in the region:

Country	Effective Tax Rate (percent)
Bulgaria	10
CSFR	22
Hungary	6
Poland	8
Romania	12

Of course effective tax rates vary from investment to investment, both because different projects have different cost characteristics that affect the definition of taxable income, and because tax regimes themselves often vary by investment. Tax regimes are often specifically negotiated between foreign firms and host governments as part of the overall foreign investment package. Investment can be re-classified into categories that qualify for tax holidays, and the length of holidays can also be extended. This discretion is in fact a characteristic of the enclave approach.

Hungary was the first CEE country to offer tax incentives, and its incentives are still the most generous. It is tempting to look to Hungary's low estimated effective tax rate and conclude that preferential tax treatment is behind the large share of foreign investment that has flowed into Hungary. Such a conclusion, however, is doubtful. Tax rates may affect short-term profits, but the evidence that they dominate or even significantly affect the investment decision of foreign

39. J. M. Mintz and T. Tsiopoulos, "Corporate Income Taxation and Foreign Direct Investment in Central and Eastern Europe," Foreign Investment Advisory Service Occasional Paper 4, 1992.

Box 1: Tax Incentives for Foreign Investment in CEE Countries

Bulgaria: Although Bulgaria substantially re-vamped its policies on foreign investment its new foreign investment law of January 16, 1992, taxes are governed by the much older Decree 56. Decree 56, issued by the State Council in 1989, sets a corporate tax rate of 40 per cent. Ventures with foreign participation exceeding $US 100,000 or 49% of total capital are taxed at 30 per cent. Joint ventures with foreign firms are exempt from all profit taxes for five years if they operate in special high-technology sectors designated by the Council of Ministers, or in agriculture or food processing.

C.S.F.R.: Corporations pay a tax rate of 20 percent on the first Kcs. 200,000 of corporate profits, and a rate of 55 percent thereafter. Corporations with foreign equity participation of at least 30 per cent pay a reduced tax rate of 40 per cent. In addition, companies with foreign participation may apply to the Ministry of Finance for two or more years of tax holiday.

Hungary: The general rate of corporate tax is 40 per cent. If capitalization exceeds HF 50 million ($US 634,000), 30 per cent of the capital is supplied by a foreign investor, and more than 50 per cent of total income is derived from manufacturing, the base rate is reduced by 60 per cent for the first five years. That is, foreign investors meeting these criteria pay corporate tax rates of only 16 per cent for the first five years, rising to 24 per cent for the second five years. Further, if the capitalization requirements are met and the business manufactures in one of thirteen priority sectors, the firm is granted a five year tax holiday, followed by a reduced rate of 16 per cent for the next five years. Reinvested profits are exempt from the profits tax. These special incentives are being phased out and will not be available to firms investing after 1993.

Poland: The basic corporate tax rate is 40 per cent. The 1988 foreign investment law granted foreign investors a three-year tax holiday, which could be extended three additional years by the Minister of Finance. The more recent law of June 14, 1991, eliminates this blanket eligibility. Holidays may still be granted if the foreign capital contribution exceeds 2m ECU ($US 2.48m) and the firm operates in regions with a risk of high structural unemployment, or if the firm introduces new technology or exports at least 20% of its total output.

Romania: Romanian law grants sector-specific tax exemptions to foreign investors. Foreign investments in manufacturing, agricultural or construction are eligible for 5-year tax holidays; those in natural resource production, transportation, or communications are eligible for 3-year holidays; and those in trade, tourism, banking, and other services are eligible for 2-year holidays. All of these tax holidays may be extended with government approval. Following the period of tax exemption, the base tax on corporate profits is 30 per cent up to Leu 1m, and 45 per cent thereafter.

entrepreneurs is decidedly mixed.[40] The majority of larger firms are investing in CEE for the

40. For a summary of the literature pro and con, see World Bank, "Attracting Private Investment: Capitalists' Perceptions of the Investment Climate in Europe, the Middle East and North Africa," EMENA Technical Department, September 1992.

long term. Tax rates are important, and investors will be deterred if taxes are set at exorbitant levels, but it is not likely that the complex packages of reduced rates and tax holidays currently in place in CEE tip the balance for many prospective investors. Many investors cannot even use the tax holidays they are offered. For example, General Electric's $US 150m purchase of 50 per cent of the Hungarian lighting manufacturer Tungsram occurred in 1989. Almost three years later, Tungsram has yet to show a profit.[41]

The emphasis on incentives has uncertain benefits but many clear costs, as has been noted in analogous discussions of tax incentives throughout the developing world. A first obvious cost is in government revenue, and this is important given the fiscal problems throughout the region. Another cost is uncertainty. In their effort to fine tune the incentives in the tax codes, the CEE countries have changed their tax regulations frequently. This has created much confusion among foreign investors and compounded their already difficult task of estimating future profit flows.

Moreover, the administrative costs of incentives are high. Complicated tax codes demand sophisticated bureaucracies to administer them. Preferential tax systems that grant benefits to foreigners must set administrative criteria to define "foreign" investment. Investments have to be screened to see if they meet the minimum levels of investment needed to qualify for preferential treatment. Monitoring mechanisms must be established to audit joint ventures to ensure that foreign participation is genuine and not just an illusion to escape corporate taxes. All CEE governments suffer from a shortage of skilled administrators. Diverting personnel to administer complex incentives of questionable worth is unlikely to be an efficient use of scarce resources.

The creation of tax incentives also creates loopholes and ambiguities in the law which firms can use to their advantage, leading to further revenue loss, creating further uncertainty, and demanding further bureaucratic intervention to control them. For example, many of the investment laws in the region allow for credits for re-investment of profits or for research and development costs. Expenses can be easily be re categorized to fit the tax-exempted classes. Or firms can manipulate the date they "start" operations to extend the tax holiday beyond the normal number of years. Furthermore, firms are adept at transferring income into and expenses out of the holiday period to minimize tax liability after the holiday expires.

Finally, preferential tax codes for foreign investors may also exacerbate political tensions in the region, both internally and externally. As noted above, charges repeatedly surface throughout the region that politicians are "selling out" to foreign interests. A clear tax code,

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41. The FIAS study noted above concluded that the tax rates of Bulgaria and Romania may be so high that they would deter investment in the absence of tax holidays. The tax regimes in Hungary, Poland, and CSFR would be unlikely to deter investment even in the absence of special incentives.

with reasonable rates and equally applicable to domestic and foreign firms, may not only be more efficient but may also remove a potentially troubling issue from the political agenda.[42] Furthermore, as the CEE states begin to enter into associate membership with the European Community, their preferential treatment of foreign investors may complicate the process. In the spring of 1992, the EC protested a decree by the Hungarian government that gave customs preferences to the Ford Motor Company in return for domestic investment.[43] The Hungarian government agreed to repeal Ford's preferential treatment, and a Ford official responded by noting, "there are easier place in the world to do business than Hungary."[44]

Conclusions

Specialized foreign investment laws have a useful role to play in the initial period of transition to a market economy. They send a strong signal to foreign entrepreneurs that the host country is serious about economic reform and is willing to work with investors to establish a mutually beneficial legal regime. These laws tend to create investment "enclaves" that not only serve this signaling function but also may target special incentives to foreigners and create an "island" of legal development that may differ from--and sometimes outpace--development in the rest of the domestic legal framework.

Yet to the extent the enclave separates foreign from domestic investors, it can quickly outlive its usefulness. The incentives it fosters not only bleed domestic treasuries, but they lead to bureaucratic structures that may unnecessarily complicate the investment environment and raise information and transaction costs for foreign investors. As quickly as possible, the transforming economies should dismantle the enclave and put domestic and foreign investors on an equal footing.[45] This may well mean that foreign investment laws are no longer needed; indeed, CSFR was the first CEE country to abolish specific foreign investment legislation in favor of a broad commercial code covering all investors in the economy.

Furthermore, if an enclave does exist, policy makers should try to focus on the concerns critical to foreign firms. In the design of investment laws to date, the CEE countries have perhaps paid too much attention to preferential tax schemes while ignoring other costs faced by foreign investors. Policy makers in reforming economies should focus primarily on reducing uncertainty and transaction costs through clear and simple legislation, dismantling of unnecessary

42. In Czechoslovakia, public protest was voiced against tax concessions demanded by Mercedes Benz in return for foreign investment. EBRD Watch, v.2, no. 4, February 3, 1992, p.4.

43. Nicholas Denton, "Hungary accused on van tariff," Financial Times, Many 30, 1992, p. 2.

44. Ken Kasriel, supra note 24, p.2.

45. Similar conclusions are embodied in the Guidelines on the Treatment of Foreign Direct Investment recently published by the World Bank Group. Legal Framework for the Treatment of Foreign Investment, Vol. II: Guidelines, World Bank Group, 1992.

bureaucratic intervention, contract enforcement, support of arbitration and other alternative dispute resolution mechanisms, strengthening protection of property rights, and active efforts to disseminate information on the legal framework and on business opportunities. Complex regulations not only increase investor uncertainty, but they divert bureaucratic resources that the host country cannot afford to squander.

The CEE states have shown remarkable willingness to restructure their legal environments to attract investment. There are signs that increasing attention is now being paid to lowering transaction costs for foreign investors. In early 1992, for example, Poland announced the creation of a new investment agency whose goal is to disseminate information and provide help to foreign investors in navigating investments through the bureaucracy. The adoption of these and similar measures in the other CEE states would further improve the overall investment climate and place them in a more advantageous position in the growing worldwide competition for scarce investment capital.

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